

DISCUSSION TOPICS

Franchise Tax Board Interested Parties Meeting - Intercompany Transactions, Regulation Section 25106.5-1 September 22, 2010

1. Background

The first interested parties meeting for possible amendments to Regulation section 25106.5-1 was held on April 21, 2010. The [Discussion Topics from the April 21, 2010 interested parties meeting](#) provided a general background of the problems being addressed and will not be repeated in this Discussion Topics.

2. Simplifying Rules at Regulation Section 25106.5-1(e)

At the first interested parties meeting, the public was invited to discuss whether to amend Regulation section 25106.5-1 to clarify how to properly execute an election under subsection (e). A [summary](#) of that meeting was posted on the FTB website. This second interested parties meeting offers an opportunity to discuss [proposed amendments to Regulation section 25106.5-1](#). What follows is a summary of the proposed amendments and then a discussion of how the comments from the first interested parties meeting were addressed.

Proposed Amendments:

- Amend Regulation section 25106.5-1, subsection (e), to add specific references stating that this is an election to recognize intercompany transaction income or loss on a separate entity basis.
- Amend Regulation section 25106.5-1, subsection (a)(5)(A), to add a subsection (a)(5)(A)4 that indicates that sales factor sourcing located at subsections (a)(5)(A) 1 through 3 applies even if a subsection (e)(2) election has been made.
- Amend Regulation section 25106.5-1, subsection (b)(6), to add a reference to subsection (a)(5) as follows, "Treatment as a separate entity means treatment without application of the rules of this regulation (other than the rules in subsection (a)(4) and (5))..."

Response to Comments from First Interested Parties Meeting:

- Effective date and Intent:

A comment was made requesting that amendments regarding the simplifying rules at subsection (e) be made prospective only on the basis that this speaker perceived them to be "changes" in the law and that this is a statutory regulation so that amendments should not be made that operate retroactively.

Pursuant to Revenue and Taxation Code section 19503(a), at its discretion, the Franchise Tax Board may prescribe that a regulation applies retroactively, if the underlying regulation relates to a statute that was enacted prior to January 1, 1998. Revenue and Taxation Code section 25016.5, the statute underlying the revisions to the intercompany transaction regulations, was originally enacted prior to 1988. Accordingly, the Franchise Tax Board may prescribe that the revisions to the intercompany transaction regulations be applied retroactively.

A full discussion of the rulemaking file for Regulation section 25106.5-1 and indications of regulatory intent is included at [Exhibit A](#).

- Economic change to the group

A comment was made at the first interested parties meeting that recognition of income should necessarily require inclusion of receipts from the intercompany transaction underlying the income. As summarized in Exhibit A, the regulatory intent was that the sourcing rules in Regulation section 25106.5-1, subsection (a)(5), should apply to all subsections of Regulation section 25106.5-1, including subsection (e). Since it was not the original regulatory intent to allow intercompany receipts to be included in the sales factor at any time when intercompany income is recognized, it is not appropriate to change the regulation to reflect other than what was originally intended. These are clarifying amendments, not substantive changes to the regulation. Exhibit A includes portions of the rulemaking file that expressed concern over manipulation if intercompany receipts were allowed to be included in the year of income recognition, and an explanation that elimination of intercompany receipts "prevents duplication and is consistent with the concept of treating unitary entities as divisions of a single enterprise." (Exhibit A, p. 3; Exhibit E, p. 4). In addition, as explained at the first interested parties meeting, this issue pertains only to transactions in the last month of the taxable year. The transactions in the first eleven months of the taxable year would normally not be subject to an election because they would have been sold outside the group within that time and currently recognized by the triggering event of the outside sale, hence not needing an election for current recognition. Double counting only the intercompany receipts from the last month of a taxable year would be even more incongruent with the original intent of the regulation.

3. The DISA rules of Regulation section 25106.5-1, subsection (f).

- Proposed Amendments

Amend Regulation section 25106.5-1, subsection (f)(1)(B), to state that a stock redemption will cause a DISA to be taken into account as income or gain.

Amend Regulation section 25106.5-1, subsection (f)(1)(B)2, to state that a merger between members of a combined reporting group will not cause a DISA to be taken into account as income or gain, if the majority of the stock of each is owned by other

members of the combined reporting group. (Subsequent provisions renumbered accordingly.)

Add Example 8 to Regulation section 25106.5-1, subsection (f)(2), to illustrate the outcome of a merger described above.

Amend Regulation section 25106.5-1, subsection (j)(4), to provide that when a member distributes an amount of money or property to a member, who in turn distributes the same amount of money or the same property to another member, the DISA that might result from the initial distribution will be treated as earnings and profits for purposes of determining the DISA that might result from the following distribution.

Add Example to illustrate the preceding.

4. Conformity with Current Version of Treasury Regulation Section 1.1502-13

- Proposed Amendment

Amend Regulation section 25106.5-1, subsection (a)(2), to indicate that the intercompany transaction regulations incorporate Treasury Regulation section 1.1502-13, as amended through April 1, 2009. Additionally, revise provision to include IRS website address.